

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION



ISAAC C. HUNT, JR.
COMMISSIONER

January 31, 2002

The Honorable John D. Dingell
Ranking Member
Committee on Energy and Commerce
U.S. House of Representatives
2322 Rayburn House Office Building
Washington, D.C. 20515-6115

The Honorable John J. LaFalce
Ranking Member
Committee on Financial Services
U.S. House of Representatives
B-301 C Rayburn House Office Building
Washington, DC 20515-6050

Dear Congressmen Dingell and LaFalce:


On November 5, 2001 you acknowledged receipt of then Commissioner Laura Unger's letter of September 20 and the Securities and Exchange Commission staff report enclosed with that letter regarding an enforcement action instituted and settled by the Commission against the New York Stock Exchange ("NYSE") on June 29, 1999. Your November 5 letter requested a follow-up report on or before January 31, 2002.

In response to your request, I am pleased to provide you with the enclosed Commission staff response. The staff response contains information not previously made public, which the Commission has authorized me to provide to you in order that we might respond to your request.

The Honorable John D. Dingell
The Honorable John J. LaFalce
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Please have your office contact Casey Carter, Director, Office of Legislative Affairs, at 202-942-0010 should you require any further assistance with this matter.

Sincerely,


Isaac C. Hunt, Jr.
Commissioner

cc: The Honorable W.J. "Billy" Tauzin
The Honorable Michael G. Oxley
The Honorable Richard H. Baker
The Honorable Paul E. Kanjorski
Mr. Richard Grasso

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**Commission Staff Response to November 5, 2001 Letter From
Congressmen Dingell and LaFalce Regarding the New York Stock Exchange**

On November 5, 2001, Congressmen John Dingell and John LaFalce wrote to Chairman Harvey Pitt and New York Stock Exchange, Inc. Chairman Richard Grasso requesting a follow up report regarding the NYSE's progress in finalizing compliance with the June 29, 1999 NYSE Order and implementing the recommendations made in the Commission's staff inspection of the NYSE and by the NYSE's independent consultant. This report responds to that request.¹ On June 29, 1999, the Commission instituted an administrative proceeding against the NYSE (AP File No. 3-9925) in which the Commission found that the NYSE failed for years to uncover and halt schemes in which NYSE floor brokers illegally shared in trading profits and engaged in other conduct violating Section 11(a) of the Securities Exchange Act of 1934, Rule 11a-1 thereunder, and NYSE Rules 90, 95, and 111. In settling the action without admitting or denying the allegations, the NYSE undertook to implement several remedial measures mandated by the Commission in the NYSE Order.

The NYSE is substantially complying with the undertakings required in the NYSE Order. Final issues are being resolved between the Commission and the NYSE as well as between the NYSE and the Independent Consultant, and the Commission will continue to monitor the NYSE's compliance with its 1999 settlement requirements.

A. Surveillance of the NYSE's Trading Floor

As noted in our September 2001 response on the status of the NYSE's compliance with the undertakings, in the most recent inspection of the NYSE, the Commission staff found that the NYSE had enhanced and improved its surveillance, examination, investigatory and disciplinary

¹ The Commission has previously provided reports on the status of the NYSE's compliance with the undertakings, pursuant to requests by Congressmen Dingell, on July 27, 2000 and September 20, 2001.

programs for floor brokers in general compliance with the undertakings outlined in the NYSE Order. The staff did find some deficiencies with respect to the requirement that the NYSE conduct “ongoing, continuous surveillance of all floor members” and “ensur[e] that members of its regulatory staff are present on the NYSE trading floor during trading hours to surveil for potential trading violations.” We previously noted that the NYSE agreed to implement specific measures to correct these deficiencies.

The NYSE has improved its surveillance programs for independent floor brokers. The NYSE is examining randomly, on an annual basis, approximately ten percent of its independent floor brokers in addition to examining independent floor brokers through its existing biannual examination program. Since the Commission staff’s inspection, the NYSE has made several modifications to the trading floor surveillance unit (“TFSU”) to establish an adequate regulatory presence on the floor of the Exchange. Specifically, the NYSE increased the number of TFSU staff positions from four to twelve, adding eight analyst positions, and also rotates a senior Market Surveillance analyst into the TFSU on a daily basis. The NYSE also amended the TFSU procedure manual to require that the TFSU staff routinely monitor trading activity at each trading post on the floor of the Exchange. Additionally, the NYSE provided the TFSU staff with a distinctive badge to identify the TFSU staff as a regulatory presence on the floor. Finally, the NYSE has stated that it is developing an automated surveillance system to identify violative on-floor trading by electronically capturing orders represented or executed on the NYSE floor. The Commission staff believes that, based on these modifications to its floor surveillance programs, the NYSE has substantially complied with the related undertakings.

B. Electronic Audit Trail

The NYSE Order required the NYSE to develop and implement two phases of systems for the electronic capture of orders represented or executed on the NYSE floor. The first phase of the Floor Audit Trail Front End Systemic Capture ("FESC") is being used to generate an electronic record of details related to orders represented or executed on the NYSE floor. The second phase of the FESC will provide an accurate, time-sequenced record of orders, quotations and transactions beginning with the receipt of an order by a member firm and continuing through that order's execution or cancellation. The Phase II also will provide for the synchronization of members' clocks with a time source designated by the NYSE.

The Commission approved the rule embodying Phase I on December 7, 2000. The new rule, codified as NYSE Rule 123(e), requires that, prior to being represented, an order, including any changes in its terms and any cancellations, must be entered into an electronic system that records: (1) the order details; (2) the time the order details were entered into the system; and (3) the time of any modification or cancellation. Phase I became effective on September 10, 2001.

The Phase II audit trail data will eventually be incorporated into a unified system with Phase I. The NYSE filed a rule proposal with the Commission for Phase II on December 22, 1999, essentially combining the existing system with the requirement to create a complete order audit trail from origination through execution and cancellation. The various data elements and information required by the proposed rule are generally comparable to the NASD's Order Audit Trail System. Under this system, NYSE members would create a unique identifier for each order that would enable the NYSE to track an order from receipt to settlement in an electronic format. Originally, the Phase II proposal required upstairs firms to process and report order information every day. However, in March 2001, the NYSE advised Commission staff that it intended to make significant

substantive and technological changes to the system as proposed. The Commission received the amendment embodying these changes on August 14, 2001, and a second amendment containing additional minor changes on January 22, 2002. The Commission published Phase II for comment on January 23, 2002.²

C. Remaining Issues Raised by the Independent Consultant

As part of other undertakings stemming from the NYSE Order, the NYSE retained Betty Santangelo as Independent Consultant. On March 9, 2001, Ms. Santangelo submitted her Independent Consultant's Report ("Consultant's Report") to the NYSE's Board of Directors. On April 23, 2001, Edward Kwalwasser, NYSE Group Executive Vice President of Regulation, presented the Independent Consultant with a memorandum detailing the NYSE's response. Ms. Santangelo has not yet submitted a finalized report that addresses the NYSE's response. According to the NYSE Order, after Ms. Santangelo submits this report, the NYSE will have 45 days to implement fully all of her recommendations. Although Ms. Santangelo is still completing her assessment of the NYSE's detailed responses, she has communicated to us her initial impression that most of the NYSE's responses satisfy her recommendations. Ms. Santangelo believes there are three main unresolved issues: (1) the creation of a special department to oversee NYSE rule making; (2) particular newly-proposed NYSE rules; and (3) the creation of a centralized filing system organized by NYSE rule.

As indicated in the Commission's September 2001 response, the NYSE opposes creating a new department to oversee rule promulgation because it believes such a department would create overlapping responsibilities. Instead, the NYSE proposes the establishment of a new permanent subcommittee that would be headed by Brian McNamara, Vice President of New Development and Market Evaluation, and report to Edward Kwalwasser, and would be charged with, among other

² Securities Exchange Act Release No. 34-45326.

things, formulating uniform procedures and a uniform system of rule codification, restructuring the NYSE rule book, and planning broad cross-training to familiarize all departments with the rules. The NYSE has also proposed changing certain rules to respond to specific recommendations by the Independent Consultant. Finally, the NYSE has also proposed an alternate centralized filing system organized by rule that differs from the filing system originally proposed by the Independent Consultant. The Independent Consultant intends to make a final evaluation of these three issues in the coming months in order to finalize her report.

The Independent Consultant also recommended that the NYSE increase coordination within the Regulatory Quality Review Department ("RQR"), as well as that the NYSE increase funding and staffing allocated to RQR for its review process. At a recent meeting, the NYSE agreed to implement all of the Independent Consultant's recommendations in this area.

D. Profit Sharing by Floor Brokers

The Commission's inspection reports did not include a discussion of the NYSE's oversight of floor broker intraday trading prior to the Commission staff's investigation of Oakford in 1998. As a result of this investigation indicating intraday trading violations, the staff conducted a focused inspection of the NYSE in March 1998. As part of its routine oversight inspections of the exchanges, the Commission staff now includes a review of the exchanges' surveillance for intraday trading by floor brokers.

E. Conclusion

The NYSE is in substantial compliance with the undertakings required in the NYSE Order. With the exception of a few remaining issues, the NYSE has almost fully implemented improvements required by the NYSE Order. The NYSE has made significant progress in

complying with the 1999 settlement requirements, including improvement in its oversight of floor brokers. The Commission will continue to monitor the NYSE's compliance with the NYSE Order.